

New Issue: [California \(State of\)](#)

MOODY'S ASSIGNS A2 RATING TO STATE OF CALIFORNIA GO BONDS

Rating Outlook Revised to Negative; \$34 Billion in Debt Affected

State
CA

Moody's Rating

ISSUE

RATING

Various Purpose General Obligation Bonds

A2

Sale Amount \$1,706,860,000

Expected Sale Date 06/19/03

Rating Description General Obligation Bonds

Opinion

NEW YORK, Jun 16, 2003 – Moody's has assigned a rating of A2 to the State of California's General Obligation Bonds, in conjunction with the state's upcoming \$1.7 billion fixed rate various purpose general obligation bond sale. The A2 rating reflects the state's broad based economy, which is projected to generate modest growth in employment and personal income through 2004, and its moderate debt burden. These credit strengths are tempered by the state's volatile tax revenue performance, which has created significant budgetary and cashflow stress for the near term, and the expectation that the budget will not be balanced on a structural basis until after fiscal 2004.

At this time Moody's has revised its outlook on the state's long-term bonds to negative from stable, reflecting the magnitude of the budget deficit and the politically polarized nature of the current legislative debate. These factors could lead to an extended delay in adoption of the fiscal 2004 budget. Reaching consensus on a final budget could be further complicated by the gubernatorial recall effort that appears to be gaining momentum. Prolonged delays in budget adoption could adversely affect the state's ability to access the capital markets to meet its cash needs in the upcoming fiscal year, and add to the already sizable budget gap in fiscal 2005.

The bonds are being issued to current refund outstanding commercial paper notes, to repay interim loans from the state's Pooled Money Investment Account that financed construction of various projects undertaken pursuant to various bond acts, to directly finance various projects authorized under various bond acts, and to currently refund and advance refund certain state general obligation bonds for interest cost savings. The general obligation refunding portion of this sale completes the state's debt restructuring plan by refunding debt coming due in fiscal 2004. The first scheduled maturity date on these bonds is February 1, 2008, with final maturity in 2033. The bonds are full faith and credit obligations of the state, and benefit from a claim on General Fund revenues that is second in priority to public education expenditures.

REVISED BUDGET PROPOSAL AWAITS LEGISLATIVE ACTION

The governor's revised fiscal 2004 budget proposal (released in May) seeks sizable expenditure reductions and tax increases in an effort to address a sizable portion of the state's budget deficit. The proposal also relies on a significant amount of one-time revenues, including the proceeds of a long-term deficit financing. Given the size of the budget deficit the state needs to address in the upcoming fiscal year, the use of such one-time budget balancing measures and the anticipated size of the structural deficit the state will face in fiscal 2005 (\$8 billion) as a result of such actions are not unexpected.

The proposed long-term deficit bond (\$10.7 billion) will be secured by a temporary ½ cent sales tax increase, and the state anticipates issuing these bonds in two equally-sized tranches in February and April 2004. The

proceeds would provide the state with significant liquidity, which would be necessary to avoid the need to exercise its standby commitments to retire its recently issued revenue anticipation warrants. However, it is unclear at this time whether political consensus can be reached on this item given the two-thirds legislative majority requirement needed to adopt revenue increases.

Overall, the revised budget proposal state's assumes the legislature will approve over \$4 billion in increased taxes, to be used to: a) support the \$10.7 billion deficit bond, and b) fund the governor's scaled-down "realignment" proposal, which seeks to shift approximately \$1.7 billion in current state expenses (primarily health and social services) to counties.

To date, minimal progress has been made by the legislature in terms of resolving its differences relative to the key components of the proposal. It is unclear what steps the legislature will take to balance the state budget if it is unable to reach consensus on these proposals.

BUDGET UNCERTAINTY CLOUDS FISCAL 2003-04 CASH PROJECTIONS

Current cashflow estimates based on the May Revision project the state will end fiscal 2003-04 with a cash balance of \$6.6 billion. The state acknowledges that this ending balance figure could fall to \$4.1 billion given certain timing-dependent budget adjustments and other factors.

Moody's has identified various pending items that could have a significant negative effect on the state's cash position in fiscal 2004 should they not come to fruition. In addition to the aforementioned \$10.7 billion deficit bond, the fiscal 2004 cashflow estimate also assumes the state will increase its motor vehicle license fee (MVLFF) by July 1st, thereby providing \$4.2 billion in cashflow relief. While current law allows the state to increase this fee without legislative authorization, a legal challenge is expected if this action is taken. The state expects it will prevail if a legal challenge arises; however, it is unclear what impact - if any - a potential challenge could have on MVLFF collections.

BORROWABLE RESOURCES CRITICAL TO STATE'S LIQUIDITY POSITION

As previously stated, the state currently projects it will end fiscal 2004 with a cash and unused borrowable resource balance of \$6.6 billion, a figure that could decline to \$4.1 billion given certain timing-dependent factors. The cash flow statement included in the May Revision anticipate the General Fund will end next fiscal year with a \$0 cash balance. Thus, the state's projected ending balance reflects the combined balances of hundreds of non-General Fund accounts from which the state may borrow on a temporary basis to meet its cashflow needs. The state has a long history of utilizing these accounts for such purpose, and the accounts have proven to be relatively insensitive to the business cycle.

The availability of these internal borrowable resources has enabled the state meet its cashflow needs given the inherent imbalance between revenue collections and programmatic expenditures. These funds have been critical over the last two years due to the dramatic fall-off in General Fund revenue collections. In fiscal 2002, total receipts of the General Fund's three primary revenue sources (personal income, sales, and corporate income taxes) were \$10 billion below original estimate - representing a 14% under-performance. The state anticipates current year collections from these three tax sources will come in \$6.7 billion below original estimate. Absent the ability to tap its borrowable resources, the state would have to rely on the short-term market to an even greater extent than it already does to meet its cashflow needs.

The projected ending unused borrowable resource balance will provide a cushion to offset any General Fund revenue under-performance that may result.

RAW SALE COMPLETED PROVIDING GENERAL FUND LIQUIDITY THROUGH AUGUST

Last week the state issued \$11.0 billion in revenue anticipation warrants, the proceeds of which will be used to retire a portion of the state's outstanding revenue anticipation notes (RAN) that mature later this month and meet the state's cash needs during the first quarter of fiscal 2004. The 2003 Revenue Anticipation Warrants (RAW) will mature on June 16, 2004. The warrants are not subject to redemption prior to their maturity.

The warrants are payable from all unapplied General Fund money and other internal borrowable resources of the state, and the state's fiscal 2004 cash flow projections reflect payment of these warrants at maturity, and estimate the state will end the fiscal year after warrant repayment with \$6.6 billion in available cash. However, these projections are based on the governor's May Revision to the fiscal 2003-04 budget proposal, and rely on several major items for which political consensus has not been reached. Given the uncertainty relative to these items, the MIG1 rating assigned to the 2003 Series A and B RAWs primarily reflects the

strength of the standby warrant purchase agreements which the state may draw upon if it is unable to retire the warrants with available cash or with a roll-over financing, and the credit strength of the agreement participants. It should be noted the agreements do not constitute an unconditional guaranty of payment of the 2003 warrants.

Under the agreements, each of the seven financial institutions participating agrees to advance to the state an amount not to exceed its commitment amount upon certification by the state controller that the state has insufficient funds to retire its 2003 warrants and is unable to issue any refunding warrants. The state may only seek an advance from the participants for the purpose of retiring its 2003 RAWs. However, the standby agreements do not allow the participants to abrogate their commitments if any state downgrades occur.

The state controller reported 52 bids had been received from 10 bidders (bidders can submit multiple bids) totaling \$38 billion, with the winning bids having an average interest rate of 1.13%. The RAW proceeds are projected to sustain the state's General Fund cash flow through August.

For further information on the state's 2003 RAWs, please see our recent High Profile New Issue Report dated June 5, 2003.

STATE ANTICIPATES MODEST ECONOMIC RECOVERY

The revenue assumptions supporting the revised budget proposal are based on a modest economic recovery that is not expected to begin until the 4th quarter of 2003. Overall the state is expected to post minimal growth in non-farm employment in 2003, but realize relatively healthy gains (as compared to the state's performance over the last 3 years) in 2004. These assumptions are consistent with consensus forecasts.

The state economy continues to slightly outpace (albeit marginally) that of the nation in terms of employment and personal income growth. It is benefiting from federal defense and homeland security spending, with orders rising among all of the state's defense contractors, particularly in aerospace and shipbuilding. Defense spending should also provide a much-needed boost to the state's tech sector. Despite this boost, the state is not expecting much of a rebound in this sector in the near term. However, the sector is not expected to be the lag on the economy that it has been over the last two years.

Outlook

Moody's credit outlook for the State of California is negative, reflecting the increased uncertainty relative to the timing of budget adoption, and the possible negative effect delay in budget adoption could have on the state's ability to manage its cash position. Given the size of the state's structural deficit, Moody's does not expect the state will fully solve the problem within the 2004 fiscal year, but our current rating does assume that liquidity measures are significantly improved via the issuance of long-term deficit bonds in 2004.

The state will need to continue to rely heavily on the short-term market to meet its cash flow needs at least through fiscal 2004. However, reliance on the short-term market presents a measure of market confidence risk. Any further deterioration in the state and national economies, or the state's inability to make sufficient progress in addressing the state's structural imbalance during the current legislative session, will necessarily place further negative pressure on the state's current rating.

Despite continuing weakness of the Bay Area's high tech economy, the state's significant economic diversity should enable the overall state economy to keep pace with the nation over the near term and exhibit positive employment growth by the end of calendar 2003.

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